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## American Institute of Accountants

### Library and Bureau of Information

JUNE, 1928

SPECIAL BULLETIN No. 31

[The Committee on Administration of Endowment authorizes the publication of special Bulletins, of which this is one, on the distinct understanding that members are not to consider answers given to questions as being official pronouncements of the Institute, but merely the individual opinions of accountants to whom the questions were referred. It is earnestly requested that members criticize freely and constructively the answers given in this or any other Bulletin of this series.]

#### ACCRUAL OF CONTRACTOR'S PROFITS

Q. Corporation A, a contracting company, has a contract with a city for the construction of four public school buildings. Corporation A turns over to corporation B the right to construct one of the buildings. The transfer of contract by Corporation A (a general contractor) to B must be and is approved by the city, but does not relieve Corporation A from responsibility for faithful performance of the contract. The moneys due under this contract are payable to Corporation A, who in turn pays them over to Corporation B. As work progresses the city engineers usually once a month estimate the work and approve payments. The contract states that the approval of payments does not mean an acceptance by the city of the work completed, but that the acceptance by the city is made only when work is completed and the last payment approved. Corporation B agrees to pay Corporation A \$100,000 for the transfer of the contract, \$25,000 of which is paid on the signing of the contract, and the balance \$75,000 payable in monthly instalments extending over a period of ten months, or \$7,500 per month. Corporation A claims that the transaction is an actual sale of a contract, hence a profit of \$100,000 should be immediately entered as such upon its books. Corporation A has the right to seize the plant, tools, etc., of Corporation B in the event of a default in the terms of the contract and has a claim upon any work performed by Corporation B, and these rights fully secure Corporation A as regards the \$100,000 profit.

Is the \$100,000 a profit on the signing of the contract, by Corporation B, and should it be immediately entered on the books of Corporation A as such?

If not, does the profit accrue pro rata as payments are made, or does it accrue only on completion of contract?

A. No, the \$100,000 is not a profit on the signing of the contract. This contract obligates Corporation "A" to fulfil the terms regardless of the performance of Corporation "B," and it is not an assured profit to Corporation "A" until the work has been approved by the city. The inquiry states Corporation "A" has the right to seize the plant, tools, etc., of Corporation "B" in the event of a default in the terms of the contract . . . and that these rights fully secure Corporation "A" as regards the \$100,000 profit.

This should secure Corporation "A"'s profit, but does it? Let us suppose that toward the completion of the work Corporation "B" had expended more than the total contract price (plus extras) and did not have funds to complete the work. It would then be necessary for Corporation "A" to step in and complete the contract, an action which might entail a net loss to Corporation "A."

We have recently had an experience of just this nature in which Corporation "A" sustained an actual loss amounting to 200 per cent. of this "guaranteed

profit" in addition to the loss of the "guaranteed profit." In this instance Corporation "A" had, in addition to the securities named in the inquiry, a further security in the form of real estate valued at about 50 per cent. more than the "guaranteed profit."

Article 36 of *Regulations 69* (the Revenue Act of 1926) permits a contractor on "long-term contracts" to report income on this basis of work completed, or upon the completion of the contract, and, in my opinion, the later course is the more conservative.

The profit may be accrued as the payments are made, as in many cases contractors accumulate and take into earnings the proportionate profits on completed work, but I believe that the more conservative method is to accrue earnings only on the basis of completed work.

A. As I understand the important features of the problem presented, they are as follows:

Corporation A has received \$25,000 and is to receive \$7,500 per month for ten months as the consideration for turning over to Corporation B the execution of a contract entered into by A, but A still stands responsible to the city for the proper performance of the contract and the city pays to A the moneys due for performance of the contract, which A in turn pays to B. Although the inquiry states that "the transfer of contract from A to B is approved by the city," it would seem (since the money is to be paid to A and A is responsible for the performance of the contract) that so far as the city was concerned, A is a contractor and B is a subcontractor to A. If this is correct then it seems to me that we should have to look on the \$100,000 as being the compensation which A receives for performance of its contract, rather than an amount paid A "for the transfer of the contract," because A apparently has not made a real transfer of the contract.

We should then be faced with the question as to whether profit on a contract is to be taken up by instalments as the work progresses or should only be taken up on the completion of the work. The principle that a contracting corporation may properly compute earnings during the progress of the work seems sufficiently recognized so that I think the generally accepted basis for such a computation might be applied to the present case. If the services and responsibilities which rest on A seem fairly measured by the initial payment of \$25,000 (say for its services in the preliminary work of plans and specifications, drafting and obtaining contracts, etc.) and its further responsibilities seem further measured by the payments of \$7,500 per month, this might be a fair measure for instalment computation of earnings. Decision on this question would, however, have to depend on a knowledge of all conditions, which is not given by the brief inquiry.

You will note that this answer is based on a belief that there has not been an actual sale and transfer of the contract, but that A still stands in the position of being the contractor, since otherwise there seems no basis for it to receive from the city the amounts payable under this contract. Under such conditions I can not see the warrant for taking up the profits in advance. The most, I think, which could be done is to take up the profits pro rata as the contract is performed.

#### MANUFACTURING CONFECTIONERS' COSTS

Q. What information can some of your members supply concerning costs of manufacturing confectioners?

Information of the following sort accepting the dollar of sales as the standard will be most welcome.

Material and supplies used . . . . .	.000
Direct labor . . . . .	.000

Factory expense.....	.000
Selling and administrative expense.....	.000
	<hr/>
Total cost and expense.....	.000
	<hr/>
Sales.....	1.000
	<hr/>

A general line of hard candies and soft-center candies selling at moderate prices is the product.

A. Following are costs of manufacture of candy:

Cost of production:	
Raw material.....	\$23.85
Packages.....	16.90
Salaries and wages.....	13.26
Supplies.....	.57
Fuel, light and power.....	1.23
	<hr/>
	\$55.81
Maintenance and repairs.....	.40
Shipping and delivering.....	1.18
General expenses (exclusive of depreciation and taxes).....	19.40
	<hr/>
Total.....	76.79
Profit.....	23.21
Sales.....	100.00

#### NEWSPAPER PUBLISHING ACCOUNTING

Q. Will you kindly obtain the following information for me on the subject of newspaper publishing accounting:

- No. 1. Determine the labor cost of the composing room per page.
- No. 2. The number of hours worked per day and the rate per hour.
- No. 3. This information to cover plants publishing both morning and evening papers.

A. The labor cost per page of the composing room of one client, publishing both morning and evening papers, was \$10.10 for the year 1926. This item may appear low compared with a company publishing only a morning or an evening paper. This is due to the fact that advertisements which are to appear both morning and evening may be set up originally for the morning edition and then used for the evening edition with very little additional cost. This reduces the cost per page nearly 50 percent. In view of the fact that this query requests information only as to plants publishing both morning and evening papers, this reduced cost of composing is probably an essential part of the comparison.

Linotype operators work 36 hours a week or 6 hours a day at a rate of \$47.00 a week for day work and \$50.00 a week for night work. Other journeymen, proof readers, etc., work 48 hours a week or 8 hours a day at the same rate per week as linotype operators.

#### PRICING INVENTORIES OF SCRAP METALS

Q. Have you the data available, or would it be possible for you to ascertain for me, what the accepted practice is in pricing inventories of scrap iron, steel and other metals?

The case in point is one in which it would not be practicable, even if possible, to ascertain the cost of scraps on hand, and in this business apparently the same market prices govern both for buying and selling, the profit often being dependent upon favorable shipping points and freight differentials.

Also in the matter of verifying quantities when it is not practicable to weigh the scrap, can approximate weights of irregular piles be ascertained by measurement?

A. We have the following comments to offer on the several queries set forth in your letter:

1. Inventories of scrap iron, steel and other metals are usually valued at the lower of cost or market.

2. It is assumed from the nature of the question that the company concerned is engaged in the purchase and sale of scrap. In which case, if costs are unascertainable, market should be used less an amount sufficient to provide for the expense of selling the scrap.

3. Most companies seem able to compute weights from measurements.

#### UNDERWRITING EXPENSES FOR MORTGAGE-BOND ISSUES

Q. One of my clients, a corporation, erected a building and as usual made a building loan. Before the building was finished, a bond issue for \$1,000,000 was arranged. The underwriting expenses, legal fees and other items in the underwriting amounted to \$90,000. The building loan was paid for out of the proceeds of the bonds. The proceeds of the bonds also supplied the funds necessary to complete the building.

The bonds were known as a 20-year sinking-fund loan and we charged off annually that portion of the \$90,000 which we felt was practicable to the year in question. The amount charged off was governed to some extent by the amount paid into the sinking fund, but the total \$90,000 was to be wiped out more or less equally over the 20 years.

The building was sold, subject to this bond issue, the purchaser assuming the obligation and relieving the seller as is customary with first mortgages when property is sold. Of course, since my client was the original mortgagee and is the corporation mentioned in the agreement when the bonds were issued, it no doubt still has somewhat of a contingent liability in connection with this bond issue. I should consider the chances rather remote of its becoming liable.

At the time of sale the underwriting expenses appeared in our books as an asset item of \$80,000 a deferred charge against future operations. In calculating our profit on the sale, we considered this as one of the cost items. A revenue officer insists that this underwriting balance of \$80,000 can not be considered so. His arguments are

- (1) The contingent liability and
- (2) The fact that my client will have other income against which it could apply this \$80,000 over the balance of the 20 years.

This is the first time in my experience that a question of this sort has been raised. It always has been generally understood that the cost of obtaining a mortgage went with the sale of the property mortgaged, and was applied against the profit.

A. We are in receipt of your letter which deals with a case in which a taxpayer claimed a deduction for unamortized expenses incident to the issuance of bonds to finance the cost of a building.

It appears that the revenue agent has disallowed the deduction claimed for such expense when the building was sold and the bonded debt was assumed by the purchaser.

In our opinion the revenue agent is in error in disallowing the deduction and in doing so is acting contrary to article 545 of treasury regulation 69. Neither of the arguments advanced by the revenue agent appears to us to be valid reason for disallowing the deduction.

You will understand, of course, that in expressing the foregoing opinion we

are simply passing on the principle involved, in the light of the facts presented in the letter. Naturally if there were any special circumstances which might be material to the question and are not brought out in the letter of your enquirer, it might be necessary to give further consideration to the question raised.

### VALUATION OF GOODWILL

Q. We have a question of placing a valuation on the stock of a very prosperous city-directory publishing company, the stockholders of which are considering a proposition of selling their stock to a printing house which prints and binds their books, because the printing house figures that it is an ideal combination.

The only point that is of any special importance is the valuation of copyrights, trade-marks, and goodwill, and I am writing to ask you what rates, in your opinion, should be used.

It has been suggested that the average net tangible assets over a period of five years are entitled to earn about 8 per cent. and that the balance of the average net earnings should be capitalized at one of three rates, namely, 10, 12½, and 15 per cent. We are naturally anxious to place as good a valuation on the stock as can be done consistently, but we want to have your opinion so as to have some authority for the figures that are used and it would be very much appreciated if you would give us an opinion on this.

A. The valuation of goodwill, under the conditions described, is primarily a matter of judgment as to the stability of the profits. Although no definite and positive rule can be laid down by anyone, there are some precedents that carry great weight, especially those set up in computing taxes, where the government often has an interest in setting the value as low as possible and the taxpayer in setting it as high as possible. Some examples of decisions reached upon these valuations are to be found in Income-tax Procedure, Montgomery, pages 509 et seq. The treasury has held that in businesses that are "more or less stable" the goodwill should be capitalized at 15 per cent. after allowing 8 or 9 per cent. on tangible assets; that is to say, the value would be 6¾ times that part of the profit for one year in excess of an 8 or 9 per cent. return on the net tangible assets. Other treasury methods of computing goodwill may be found on pages 512 et seq. of the book referred to above.

### VALUATION OF LICENSED ABSTRACTORS' BUSINESS

Referring to the question and answer in Bulletin No. 30, we have received the following from a correspondent:

The questions relative to valuation of licensed abstractors' business, appearing in the special volume No. 30 are not, in my opinion, fully answered in the answers listed.

The question purely outlines how often at times, the public accountant's work touches that of an appraiser and how a theoretical answer must be qualified or adjusted to give effect to business conditions not clearly reflected by percentages or mathematical computation.

In the valuation of an abstract office, much weight must be given to the increase or decrease in property transfers, as set forth in the past, and what may reasonably be expected in the future. If the abstract office is covering a district that is undergoing a development that may be expected to increase rather than decrease, the matter of cost of establishing the basic books of the abstractor is of importance and should be taken in consideration, in my opinion, in addition to any goodwill earning power that the business has shown.

On the other hand, if the locality has been subject to a retarding movement and real estate transfers have shown little or no increase in volume with the

possibility of a small decrease, the previous earning power may, when capitalized, over-state the value.

This is a particular type of business where, in my opinion, it is incumbent upon the accountant to examine the business itself and its future prospects and until this has been done, the capitalizing of earning power is liable to be very misleading even when abnormally high or low years are excluded.

#### VERIFICATION OF CUSTOMERS' SECURITIES

Q. In the preparation of answers to the New York stock exchange questionnaire for brokers, we should appreciate it if you would advise us as to the detail of verification of customers' securities held by the broker.

We are particularly anxious to obtain information as to whether it is possible to obtain this information without listing in detail each customer and the security held by him.

A. The subject is governed by the printed regulations prescribed by the committee on business conduct of the New York stock exchange for audit under authority of chapter XV, section 2 of the rules adopted by the governing committee, pursuant to the constitution. These rules relate specifically to the questionnaire, and prescribe, in part, as follows:

"Ledger balances and securities shall be verified. Written confirmation of the following should be obtained."

Among the items listed thereunder are:

*Customers' accounts:*

- Ledger balance
- Securities long and short
- When issued contracts
- Open commodity contracts

The answers to the questions, therefore, are: (1) that customers' securities held by the broker require to be verified in detail, and (2) that listing in detail each customer and his securities is essential for that purpose.

The verification of customers' securities divides itself into two parts, namely, ownership and location.

Ownership is verified by sending to each customer a statement of his account as it stands on the broker's books and requesting confirmation of the money and security balances as at the date of the examination.

Location is verified by tracing the securities through the security-position records to their location as being either on hand, in loans, in transfer, or with other brokers, all of which are verified either by count or by confirmation.

The listing is usually made, for customers in the form of a trial balance, for securities on the confirmation forms.

In relation to customers' securities held in safekeeping, the regulations prescribe as follows:

"Securities in safekeeping shall be inspected and checked with the office record and a written confirmation obtained from the owner."

Here again the answers would, therefore, be the same.